What Can I Expect From My Portfolio?

For many investors the capital markets appear to be a conundrum: Stocks are supposed to outperform bonds but did not this last decade, stocks have risen on negative news and fallen on positive news. And what can we tell you about the US dollar with its huge debt and struggling economy?

This conundrum leads many investors to wonder: "What can I expect from my portfolio?"

The poor equity investment returns over the past 10 years has sent many investors, investment managers, pension consultants and others back to the drawing board. Why? Because financial planning and capital budgeting are based upon long term positive returns. The abruptness and severity of negative returns in 2008 and early 2009 should have caused investors to re-visit the more important questions: "Will I be OK?" Or, alternatively "Will I have sufficient money to meet my life goals?" (e.g. retirement, travel, education, charity, etc.).

While the positive market returns for the balance of 2009 provide some breathing room and certainly helped provide some comfort that the "sky is not falling" , many investors are still nervous. "Will staying invested get my financial road map back on track?", "What do I need to earn from my portfolio to be financially independent and can I reasonably expect to earn that? ". Good questions that can only be answered with an understanding of how the capital markets are priced. Notwithstanding the uncertainty in the returns in the capital markets, investors still need to plan and understand their options.

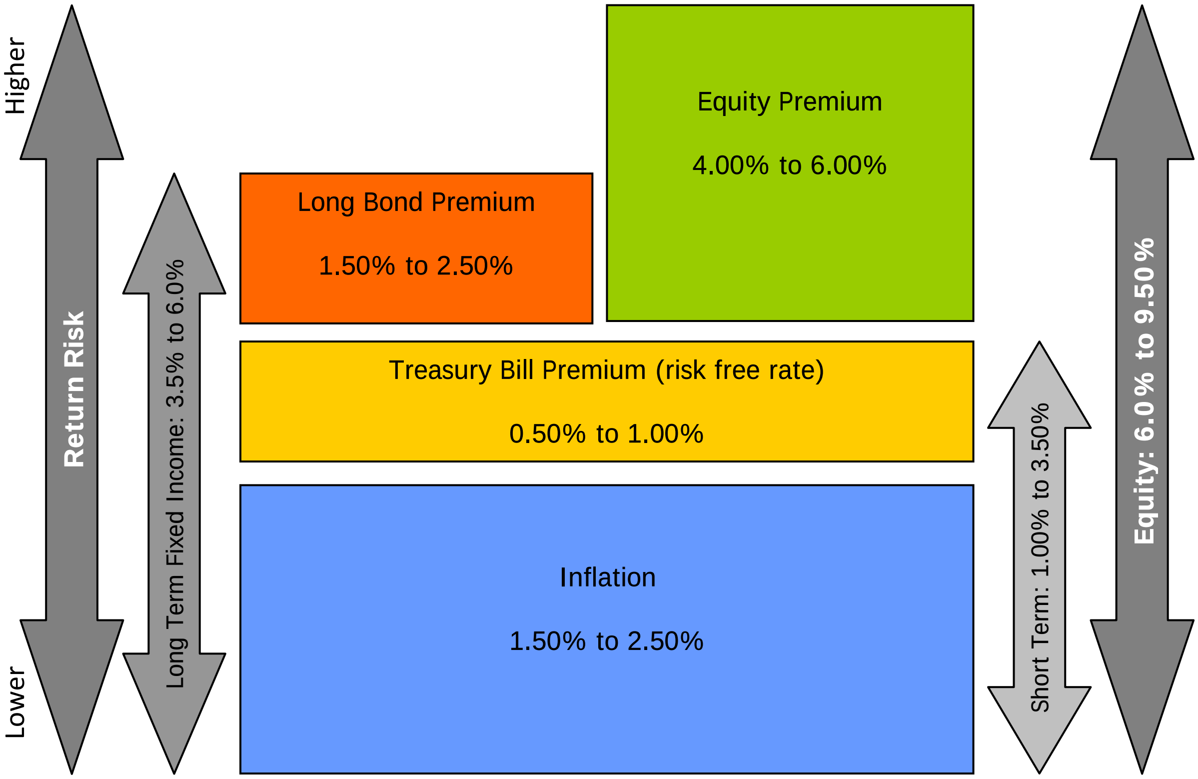
So really what we want are the inputs to estimate future levels of wealth to determine where we are financially on our goals (and hopefully use this information to make decisions). This is the end game.

Estimating Future Rates of Return

The future is by definition unknowable. It is impossible to predict in advance all the details of the complex world we live in and then translate that into the impact on various investments. The lack of precision should not prohibit us from making reasonable estimates of future returns which will ultimately be used for our own planning.

Theory (and logic) suggests that investors are compensated through a higher rate of return on investments that are considered more risky. A summary of the components of return by asset class will reveal which inputs we will need to factor into our planning in order to provide a reasonable estimate of future returns. The following chart illustrates current expected returns and risk premiums :

Building Blocks of Investment Return



It should be apparent that nominal return expectations need to be reduced based upon current and future risk premiums. With short term funds currently returning only 0% - 3.5% per annum, even with a 6% equity premium the long term return expectation for equity can only be 6% - 9.5%.

Fixed income

Interest rates and bond prices have an inverse relationship. If interest rates rise, bond prices fall; if interest rates fall, bond prices rise.

The period since 1981 to now has been a great one for bonds. Investors enjoyed returns of 16-18% (in the early 1980's) as interest rates declined over the next few decades. If we believe that interest rates will rise in the future, then bond prices have to fall. With massive government deficits to finance and a possibly falling demand for government debt as boomers retire (and spend not save) it is easy to build a case for increased yield on bonds. The expectation of inflation in the long term will also push up rates.

The current yield curve (i.e. March 2010):

Term (years)	Federal Government	Investment Grade Corporate	Spread
2	1.6%	2.0%	0.4%
5	2.8%	3.5%	0.7%
10	3.7%	4.3%	0.6%
20	4.1%	5.6%	1.5%

We are in a low interest rate environment. Many investors are searching for yield and may or may not realize that higher yield only comes with higher risk. Given the current low yields on fixed income, if future interest rates rise the returns from current investments in fixed income could be negative (more so for longer dated maturities).

Equities

The sources of return for equity investments are different from fixed income. The return to an investor is comprised of:

1) Dividend yield;

2) Growth in dividend yield; and

3) Increase/decrease in the multiple (Price / Earnings) an investor is willing to pay.

The current dividend yield is around 3%. Dividend growth tracks the growth in earnings (the "E" in the P/E ratio) which has been about 3% for the broad equity market over long periods of time. The current P/E of 15 is around the long term average implying stocks are "fair value" (as opposed to "very cheap" or "very expensive").

It is very difficult, if not impossible, to predict future returns on equity investments over short periods of time. Investors generally believe that over longer periods of time the return on equities will be greater than fixed income. The logic is that to stay in business companies must earn at least their cost of capital which is the yield they must pay on their bonds. If companies raise capital through issuing equity (which ranks behind debt) investors expect to be paid a higher return for equity exposure than debt.

The question then becomes how large is the equity risk premium (the "ERP")? While we will only know for certain with the benefit of hindsight, expected long term returns on equities could be between 6% and 9.5% depending on investor's starting point and the time horizon (i.e. 5, 10 or 15+ years).

Putting it All Together

Recognizing various portfolio compositions over a 10 year time horizon, and ignoring fees and any returns from active management, an approach to estimating future returns on a tax exempt portfolio might look like:

Portfolio	% Fixed	% Equity	Return – Lower Range	Return - Upper Range	Return – Median	Treasury Bills	Excess over Treasury Bills
A	70%	30%	4.2%	7.0%	5.6%	1%	4.6%
B	50%	50%	4.7%	7.7%	6.2%	1%	5.2%
C	30%	70%	5.2%	8.4%	6.8%	1%	5.8%

Taking into account the tax treatment of the various investments and assuming a tax rate of 45% (and tax differences between interest, dividends and capital gains) the portfolios would produce after tax returns of:

Portfolio	% Fixed	% Equity	Return – Median	Treasury Bills	Excess over Treasury Bills
A	70%	30%	3.6%	.5%	3.1%
B	50%	50%	4.3%	.5%	3.8%
C	30%	70%	4.9%	.5%	4.4%

The above charts do not consider any outperformance in any given year.

A difference of 1% or 2% may not seem like much but over time through compounding the results are quite material. $100,000 invested at 4% per annum for 20 years is worth $219,000. At 6% the same $100,000 after 20 years is worth $320,000. The issue for most investors is to balance the risk with reward by seeking the highest return possible (more $ is better) up to the point of being able to sleep well at night.

Of course using a future return on the high side of an estimate will make your future financial position look better. We can always handle the positive surprises. To help us better understand our future financial position it is prudent to plan our future financial well being under a variety of scenarios and although it will be emotionally difficult, at returns at the low end of the range.

But as we consider the building blocks of returns, it should be apparent that we must reduce our expectations for double digit returns from our portfolios. This does not mean that there cannot be positive surprises but planning cannot rely on this.

As investment advisors, Quadrant continually reviews asset mixes and asset classes to position portfolios to achieve realistic long term returns and assist clients in getting paid (in terms of return) for the risk taken. As wealth managers, Quadrant continually reviews the objectives of families and institutions to guide them toward long term objectives.

“What Can I Expect from my Portfolio?” Well, based on the building blocks, not much if you are mostly invested in fixed income; but a portfolio comprised of mostly equities can still be quite volatile in the short term. Quadrant opts for a balanced approach but with a view to consider asset classes that offer more yield on fixed income and more upside on equities.

Analyzing rates of returns is pervasive in the investment world but integrating them into the more important question of “Will I be OK?” is not as widespread. As seen by the building blocks above, such planning has to be based upon reasonable expectations from your portfolio.

2009 Q4 Commentary

TAX FREE *SAVINGS* ACCOUNTS – NOT?

There has been a lot of media attention given to Tax Free Savings Accounts (TFSA). However, the name and marketing by financial institutions has (mis)led many investors to treating a TFSA as a "Savings" account rather than an "Investment" account. The result is that a TFSA would hold short term investments yielding barely 3% for a 3 year lock-in and even less if held in shorter term deposits. If the institution charges any fees, the benefit of the "Tax Free" aspect of the account is almost entirely eroded. For instance a 3% return on $5,000 results in a tax saving of $70 for a high marginal rate taxpayer. Quadrant believes that a TFSA should hold the equity asset classes or high yield fixed income of a portfolio which have the greater opportunity for a TFSA to shelter growth. Although the amount an individual can currently deposit in a TFSA is only $5,000 per annum ($10,000 per annum for a couple), the amount of the tax shelter will become more meaningful over time. For example, over a period of 10 years a couple will have the opportunity to contribute $100,000 to their TFSAs. The power of compounding tax free (Albert Einstein would be proud) makes a TFSA a must account for all investors over 18 years of age.